Internal Revenue Service
memorandum

CC:TL:Br2
LEGardner

date: SEP 6 1991

to: Lawrence C. Letkewicz,
Special Trial Attorney, Midwest Region CC:MW

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your request for Tax Litigation Advice, dated June 7, 1991.

ISSUE

Whether Treas. Reg. § 1.1502-13(g) is valid, and, if so, whether it is applicable in this case.

Recommendations

We conclude that Treas. Reg. § 1.1502-13(g) is valid and applicable and, therefore, the gain in this case should be reported as short-term capital gain.

FACTS

[redacted], ([redacted]) is a Missouri corporation. [redacted] ([redacted]) is a wholly owned subsidiary of [redacted]. [redacted] was incorporated [redacted], for the primary purpose to purchase, own, and hold stock of other corporations. [redacted], ([redacted]) was another wholly-owned subsidiary of [redacted]. [redacted], ([redacted]) was organized by [redacted] in [redacted] with [redacted] contributing the stock of [redacted] to [redacted]. [redacted] became the wholly-owned subsidiary of [redacted]. [redacted] owns nearly [redacted] percent of the outstanding stock of [redacted]. The remaining stock is publicly held. [redacted], [redacted], and [redacted] are members of an affiliated group of which [redacted] is the common parent. [redacted] files consolidated income tax returns with its subsidiaries, utilizing a fiscal year ending [redacted].

During the period beginning [redacted], to and including [redacted], [redacted] purchased [redacted] shares of common stock of [redacted], ([redacted]), an unrelated bank holding company. On [redacted], [redacted] distributed all [redacted] shares to [redacted]. [redacted] then transferred these shares to [redacted], which at the time was a wholly owned subsidiary of [redacted]. During the period beginning [redacted], to and including [redacted], [redacted] purchased an additional [redacted] shares of [redacted] common stock. This brought the total holdings of [redacted] to [redacted] shares. At this time, it is not known whether the total holdings of [redacted] common stock constituted [redacted] percent or more of [redacted]'s common stock.[1] [redacted]'s basis in these shares was $[redacted] as of [redacted].

On [redacted], [redacted] sold its [redacted] shares of [redacted] to [redacted] for $[redacted], consisting of $[redacted] cash and a note for the remaining $[redacted] in a deferred intercompany transaction. [redacted] reported that [redacted] had an adjusted basis in these shares of $[redacted]. The consolidated return for [redacted] for the year ended [redacted], reflected a deferred gain on this sale of $[redacted], equal to the $[redacted] sales price less [redacted]'s basis in the [redacted] shares of $[redacted].

In [redacted], [redacted] purchased an additional [redacted] shares of [redacted] for $[redacted]. This brought its total holdings to [redacted] shares at a total cost of $[redacted]. [redacted]'s cost basis in these shares was $[redacted].

On [redacted], [redacted] had held all of the [redacted] shares of [redacted] common stock for less than one year. On [redacted], and [redacted], [redacted] repurchased all of the [redacted] shares from [redacted] for $[redacted]. At that time, [redacted] also paid [redacted] $[redacted] which represented the profit realized by [redacted] as a result of the sale and which was recoverable by [redacted] in accordance with Section 16(b) of the Securities Exchange Act of 1934. On the consolidated return for the year ended [redacted], [redacted] reported a long-term capital gain of $[redacted] from the sale. (Sales price of $[redacted] less basis of $[redacted] less $[redacted] paid to [redacted].)

The statutory notice of deficiency recharacterizes $[redacted] of the reported gain for the year ending [redacted], as short-term gain rather than long-term gain. This adjustment was computed as follows:

Reported long-term gain	$ [redacted]
Long-term portion of deferred gain on [redacted]-[redacted] sale (uncontested)	
Fees on sale	
Short-term gain	$

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[1] If [redacted] owned [redacted] percent or more of [redacted]'s common stock, ordinary income (dividend) treatment may be appropriate under section 304.

DISCUSSION

Petitioner presented two arguments for claiming long-term capital gain rather than short-term capital gain on the sale of the [redacted] shares to [redacted]. First, petitioner contends that the [redacted] transaction was not a sale, but a transfer of property solely in exchange for cash and securities qualifying for non-recognition treatment under section 351, with [redacted] taking [redacted]'s holding period under section 1223(2). This office has not been requested to comment on this argument. We will be happy to respond to any inquiries if questions arise later.

Second, petitioner contends that Treas. Reg. § 1.1502-13(g) is invalid. According to petitioner, [redacted]'s holding period for the stock in question should include [redacted]'s holding period since the group held the stock for an uninterrupted period of more than one year. The [redacted] group held most of the stock, except [redacted] shares, for an uninterrupted period of more than one year. Therefore, according to petitioner, the gain thereon should be taxed as long-term capital gain.

Pursuant to Treas. Reg. § 1.1502-13(a)(1), an intercompany transaction is a transaction during a consolidated return year between corporations which are members of the same group immediately after such transaction. In this case, there was an intercompany transaction between [redacted] and [redacted]. Treas. Reg. § 1.1502-13(g), provides:

> In determining the period for which a purchasing member has held property acquired in a deferred intercompany transaction, the period such property was held by the selling member shall not be included.

Pursuant to Treas. Reg. § 1.1502-13(g), the holding period of the stock in question in the hands of [redacted] began on [redacted], the date [redacted] acquired the stock from [redacted]. The holding period was less than one year, therefore, the gain is short-term capital gain, not long-term. See sections 1222(1) and (3), as in effect at the time, i.e., for the year ended [redacted].

An affiliated group of corporations has the privilege of making a consolidated return. Section 1501. Pursuant to section 1501, this privilege is accorded if the members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to filing such return. Filing a consolidated return is, however, considered as such consent. Consent means that the group agrees to be bound by the regulations. American Trans-Ocean Navigation Corp. v. Commissioner, 229 F.2d 97 (2nd Cir. 1956). The consent requirement has been invoked to place a heavier burden on any taxpayer attempting to establish that the regulations are invalid. Valley Paperback Manufacturers, Inc. v. Commissioner, T.C. Memo. 1975-311; see also Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685 (5th Cir. 1954). [redacted] and its affiliated group have consented to all the consolidated return regulations, including Treas. Reg. § 1.1502-13(g), by virtue of making the consolidated return.

Such consent does not prevent petitioner from challenging the validity of the regulations. However, the only effective basis for attacking the validity of the regulation is: (1) It is inconsistent with statutory provisions, or (2) it is unreasonable. Allied Corp. v. United States, 685 F.2d 396 (Ct. Cl. 1982); Union Carbide Corp. v. United States, 612 F.2d 558 (Ct. Cl. 1979); American Standard, Inc. v. United States, 602 F.2d 256 (Ct. Cl. 1979); American Trans-Ocean Navigation. Corp. v. Commissioner, supra; Kanawha Gas & Utilities Co. v. Commissioner, supra; Corn Broadway-Maiden Lane, Inc. v. Commissioner, 76 F.2d 106 (2nd Cir. 1935); American Water Works Co. v. Commissioner, 25 T.C. 903 (1956), aff'd in part and rev'd in part, 243 F.2d 550 (2nd Cir. 1957); Trinco Industries, Inc. v. Commissioner, 22 T.C. 959 (1954). Our position is that Treas. Reg. § 1.1502-13(g), is consistent with the statutory provisions and is reasonable.

Section 1502 provides:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

The consolidated return regulations "are legislative in character and have the force and effect of law." Union Electric Company of Missouri v. United States, 305 F.2d 850, 854 (Ct. Cl. 1962). The consolidated return regulations will be consistent with statutory provisions and reasonable if such regulations effectively prevent tax avoidance and/or help to reflect income clearly. Commissioner v.General Machinery Corp., 95 F.2d 759 (6th Cir. 1938). The determination of reasonableness of a regulation requires "an examination of the purposes and policy of the statute and regulations." American Standard, Inc. v. United States, supra at 261. A challenge to the consolidated return regulations has been successfully maintained where the

Commissioner failed to introduce evidence to explain why the limitation provision of the regulation is justified under the law. Joseph Wiedenhoff, Inc. v. Commissioner, 32 T.C. 1222 (1959). Treas. Reg. § 1.1502-13(g), helps to reflect income clearly and effectively prevents tax avoidance.

Prior to 1966, the consolidated return regulations generally treated the consolidated group as a single entity. It was recognized that corporations in many cases acted as a business unit and, therefore, it was appropriate to treat items of the business group as belonging to one entity. In an intercompany transaction, any realized gain was eliminated by the selling member and the purchasing member would use the selling member's basis. With such treatment, gains or losses were improperly attributed to the wrong member of the consolidated group resulting in the understatement of the selling member's earnings and profits. Correspondingly, purchasing member's earnings and profits were overstated.

The defect in the regulations became apparent in Beck Builders, Inc. v. Commissioner, 41 T.C. 616 (1964), aff'd, 433 F.2d 309 (5th Cir. 1970). In Beck Builders, the parent in an affiliated group was organized to construct and manage a housing project for its subsidiary. The subsidiary purchased the housing project from the parent at a fair market value price and paid for it with loan proceeds. Upon receipt of the project, the subsidiary took the parent's cost basis. The parent realized gain on this transaction but properly eliminated the gain in determining the net income for the consolidated return, as prescribed under the regulations in effect at the time. Later, the parent sold all of the outstanding common stock of the subsidiary to an unrelated party. Within a few days after this transaction, the unrelated party liquidated the subsidiary and received the assets, principally the project, subject to liabilities. Respondent determined that the gain which was eliminated in the intercompany transaction constituted ordinary income to the parent on the occasion of its sale of the subsidiary's stock to the unrelated party. Respondent argued that this result was necessary so that the gain would not escape taxation altogether. The Tax Court noted that neither the Code nor the regulations provided for taxing the eliminated gain in such a situation and that the regulations created a "loophole" in the law. In this case and others that followed, the eliminated gain escaped taxation altogether because neither the parent nor the subsidiary recognized the group's gain with respect to the housing project, i.e., the parent ends up with a cash amount greater than its cost outlays and such amount is never included in the group's income.

After Beck Builders, to prevent such tax avoidance and to ensure that income is clearly reflected, Congress made extensive revisions of the consolidated return regulations, especially in the area of intercompany transactions. The regulations moved toward separate entity treatment for certain items. The revised regulations extend the general approach of normal accounting practice which attributes to each participating affiliate the profit or loss which it actually earns or incurs. The result is that the income ultimately realized after the sale to an unrelated group is reported by the member which earned it. The revised regulations actually contain single and separate entity concepts, offering a hybrid approach. The single entity concept is apparent in the rules for investment tax credit, net operating losses, and investment adjustment rules regarding intercompany dividend distributions. The separate entity concept is apparent in the methods of accounting.

In an intercompany transaction, under the regulations as revised, gain is deferred instead of eliminated. Treas. Reg. § 1.1502-13(a)(2), defines a deferred intercompany transaction as a "sale or exchange of property, * * * in an intercompany transaction." Treas. Reg. § 1.1502-13(c)(1), provides that the recognized gain on a deferred intercompany transaction in a consolidated return year is deferred by the selling member. This deferred gain is taken into account on the consolidated return on "the date on which such property is disposed of outside the group." Treas. Reg. § 1.1502-13((f)(1)(i). As a result, the gain in an intercompany transaction is not lost, but is appropriately taxed; the gain is attributable to the member of the consolidated group which earned the income; the characterization of the gain is proper, and the earnings and profits of each member are properly reflected. Such deferral is evidence of the single entity concept because the consequences of the transaction between members of the group are deferred until the transaction has an impact on the group as a whole. The separate entity concept is evident in the treatment of gain, basis, and holding period.

The holding period is the length of time between the date when the taxpayer acquires the property and the date when he disposes of the property. Under Treas. Reg. § 1.1502-13(g), the holding period for which the purchasing member has held property acquired in a deferred intercompany transaction does not include the holding period for which the property was held by the selling member. The gain will be short or long-term gain depending on the holding period. Treas. Reg. § 1.1502-13(g) treats the members as separate entities for purposes of determining the holding period of the purchasing member in a deferred intercompany transaction.

This treatment is consistent with the treatment of basis under Treas. Reg. § 1.1502-31(a). Treas. Reg. § 1.1502-31(a) provides that the basis of property acquired by a purchasing member in a deferred intercompany transaction is determined as if separate returns were filed. The purpose of Treas. Reg. §

1.1502-13(g), is to provide the same holding period treatment as would be provided if a member of the group were filing separate returns. In the absence of Treas. Reg. § 1.1502-13(g), section 1223 would apply. The result would be the same. Such treatment provides for a clear reflection of income by attributing an item of income to the party which earned the income. Treas. Reg. § 1.1502-13(g) is consistent with the requirements of section 1502 and is reasonable in that the regulation is consistent with the separate entity approach.

To bolster the above arguments, you might add the fact that Congress has not legislated in detail in this area, leaving the Secretary to prescribe regulations in this area. See Carboloy Co., Inc. v. Commissioner, 18 T.C. 1028 (1952); aff'd, General Electric Co. v. Commissioner, 207 F.2d 777 (6th Cir. 1953). The courts rely on the doctrine that consistent long-standing regulations, coupled with a history of either reenactment of underlying statutory authority or abstention by Congress from any change in statutory language, are at least presumptively valid. Regal, Inc. v. Commissioner, 53 T.C. 261 (1969), aff'd, 435 F.2d 922 (2nd Cir. 1970); Gottesman & Co. v. Commissioner, 77 T.C. 1149 (1981).

This office has reviewed the material in the background file for the regulation and have enclosed copies of a Technical Information Release and a draft Memorandum which discuss the reasons for the changes in Treas. Reg. § 1.1502-13. We have also enclosed a copy of temporary and final regulations published in the Federal Register, dated March 14, 1990, which provides background information on the changes made to the regulations in 1966 with respect to the deferral system. We believe that Treas. Reg. § 1.1502-13(g) is consistent with the overall purpose of the deferred intercompany mechanism of Treas. Reg. § 1.1502-13: to accurately affix the location, character, and source of any gain or loss on transactions between members of a consolidated return group. Therefore, we conclude that Treas. Reg. § 1.1502-13(g) is valid and applicable in this case. If you have any further questions, please contact Lorraine E. Gardner, (FTS) at 566-3470.

MARLENE GROSS

By: Steven J. Hankin
STEVEN J. HANKIN
Senior Technician Reviewer
Branch No. 2
Tax Litigation Division